Rep. Spencer Bachus
Chairman
Subcommittee on Financial Institutions and Consumer Credit
Hearing on Merchant Banking
April 4, 2001

Thank you, Chairman Baker, for convening this joint hearing of our two subcommittees to review the revised merchant banking rules recently published by the Federal Reserve and the Department of the Treasury.

One of our Committee's central responsibilities in this Congress will be overseeing regulatory implementation of the historic Gramm-Leach-Bliley financial modernization legislation enacted by the last Congress. Among the issues that will need to be addressed are the far-reaching financial privacy regulations scheduled to go into effect on July 1, and a more recent regulatory proposal that would permit banks, through financial holding companies and financial subsidiaries, to engage in real estate brokerage and management activities.

Though the privacy and real estate rules are of greater interest to individual American consumers, the merchant banking rules first proposed in March of last year have enormous consequences for the financial services industry and for the capital formation process that helps fuel our economy. Private equity placements and venture capital investments provide critical seed money for America's entrepreneurs, whose creativity and energy have helped make the U.S. economy the envy of the world.

I was one of those Members who felt that, as originally proposed by the regulators last March, the merchant banking rules were deficient in several important respects. Particularly troublesome was the requirement that financial holding companies hold 50 cents in capital for every dollar of equity investment in non-financial companies. By setting the capital threshold so high, the original capital rule served as a huge disincentive for any investment banking firm thinking of partnering with a depository institution under the financial holding company structure established by Gramm-Leach-Bliley.

To their credit, the regulators took the criticisms of their original proposal to heart, and have come back this year with rules that clearly move in the right direction. Most importantly, the revised proposal replaces the rigid 50 percent capital requirement with a more flexible "sliding scale" approach that increases (or decreases) the capital charge imposed on merchant banking investments in direct proportion to the concentration of such investments in an institution's portfolio.

But acknowledging that a bad proposal has been made better is not the same thing as concluding that the proposal was a good idea in the first place. In my mind, the Federal Reserve and the Treasury have simply not met their burden of proof in demonstrating that additional regulatory requirements are needed in the merchant banking arena.

Banking organizations have been making private equity investments pursuant to other statutory authorities since well before Gramm-Leach-Bliley was enacted, and have done so profitably and seemingly without loss to individual institutions, depositors, or the system as a whole. This track record strongly suggests that bank regulators already have the legal tools needed to effectively supervise merchant banking activities of financial holding companies and bank holding companies without these new rules.

Even with the welcome improvements made by the regulators, the revised merchant banking rules still place financial holding companies at a decided competitive disadvantage in relation to firms that choose to operate outside of that structure. Such a result cannot be squared with the congressional intent evidenced by Gramm-Leach-Bliley, which was to encourage - not actively impede - affiliations between securities firms and banks. This regulatory initiative before us greatly concerns me.

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